Vontobel

Asset Management

Why invest into emerging markets?

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Frank Häusler joined Vontobel Asset Management's Multi Asset Boutique as Head of Macroeconomic and Cross-Asset Research in 2018 and became OCIO the same year. He is responsible for the investment strategy and a voting member of the Asset Allocation Committee.

Prior to joining Vontobel, from 2014 to 2018, he worked at Marcuard Family Office as Chief Investment Officer and was in the Investment Advisory Board of a large US family office. Previously from 2009 until 2013, Frank served in various positions at Wegelin Private Bank and one of its successor organizations, 1741 Asset Management. His positions included Head of Research, Head of Portfolio Management and finally, CEO of 1741 Asset Management. Additionally, he was the portfolio manager of award winning liquid alternatives funds.

Frank graduated from ETH Zurich with a master's degree in mathematics.

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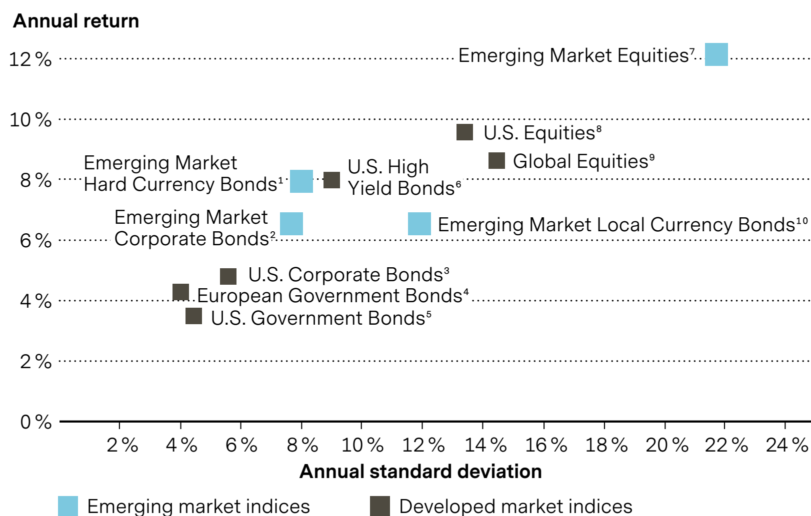
Why invest into emerging markets?

Emerging market assets have always been alluring to investors because of their attractive risk-return characteristics (see chart 1). Nevertheless, investors dedicated only marginal portfolio allocations to this asset class in the past. However, recently, these allocations have been rising. Current estimates on Swiss pension fund allocations to emerging markets range from 5 to 7% and they continue to grow. Dutch pension funds have already taken a leap forward by allocating as much as 15% to emerging markets. This indicates that acceptance among investors of emerging markets as an asset class is increasing and also reflects the fact that emerging markets are now treated as a separate category. For example, leading Swiss pension fund indices, such as the Pictet BVG 2015 Index family, now include a separate emerging market bond component of 5% for all client risk profiles. However, our view is that for many investors, an allocation of 5% is far too low.

Growing strategic allocations to emerging markets come with challenges. This paper sheds light on the forces driving the fundamentals of emerging markets on a strategic level and challenges some of the most common beliefs that investors hold on emerging market equities and bonds. Then, we reveal the key factors to consider when defining your emerging market investment approach.

Chart 1: Emerging market assets exhibit compelling risk-return characteristics



The following indices have been used:
[1]JPM EMBI GD (HC) [2]JPM CEMBI (EM Corp) [3]ML US Corp [4]ML Euro Govt.
[5]ML US Treasury [6]ML US High Yield [7]MSCI EM [8]S&P 500 [9]MSCI World
[10]JPM-GBI GD (LC)

Source: Vontobel Asset Management, Bloomberg, as of June 29, 2018

Emerging market investments are risky, but not in the way most people think

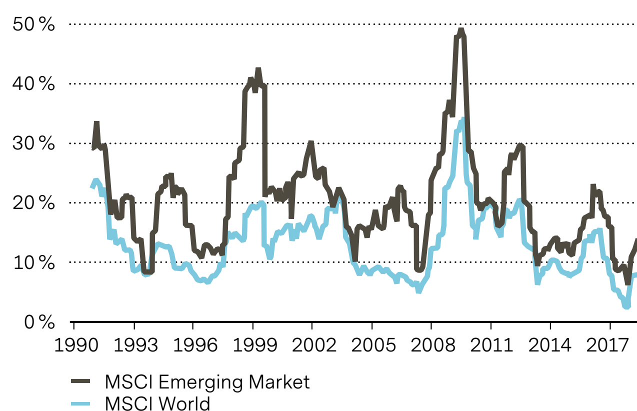
Most people assume that emerging markets are more risky than developed markets, and, therefore, that a limited allocation to emerging markets keeps portfolio risk on a short leash. This is true, but it's not the full story. Chart 1 on page 3 shows that emerging market investments yield around 3% more than their developed market equivalents. Closer inspection also shows that emerging market hard currency bonds have similar characteristics to U.S. high yield bonds and are far more attractive on a risk-return basis than the S&P500 or the MSCI World index. So, it is surprising that people are very comfortable to invest large allocations into equities, but only small single-digit percentages into emerging market bonds.

Having said that, emerging market assets are affected more violently by economic cycles and short-term corrections which result in drawdowns (see charts 2 and 3). In fact, emerging market assets are among the first ones to be sold when markets go through periods of stress. This is because emerging market assets are primarily held by foreign investors and, therefore, lack a natural home base of buyers. In addition, foreign investors tend to use emerging markets as a tactical tool to increase returns in the short term, rather than making a long-term strategic commitment to them. In up markets, emerging markets are a welcome return booster whereas in down markets they are considered a dangerous Pandora's box to be disposed of quickly. These dynamics amplify the effects of economic downturns and other fleeting corrections that are accompanied by large-scale sell-offs.

Our analyses show that emerging markets are as risky as ever, since the frequency and depth of drawdowns has not decreased over the past few years (see chart 3). This is a key issue especially for investors whose asset base is denominated in a safe-haven currency (i.e. the Swiss franc) since they will incur currency losses in most foreign assets when other investors flock to their home markets in times of crises. However, one should not overlook the 3% additional returns that emerging markets offer. This return cushion represents a huge opportunity for investors able to take a longer view to ride out periods of volatility or invest during periods of emerging market stress.

Chart 2: Emerging market equities are more volatile than their developed market equivalents

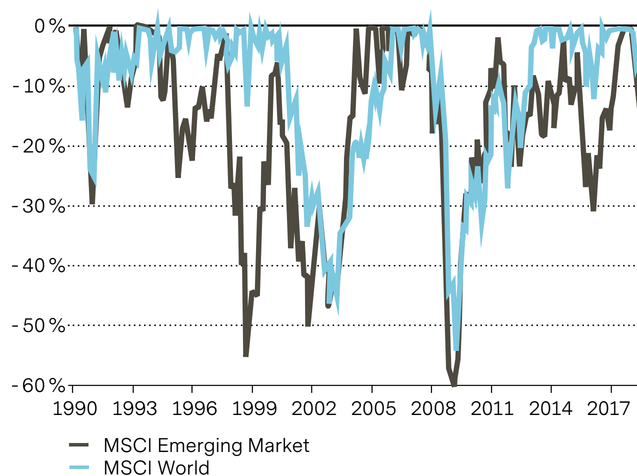
Standard deviation of returns p.a.



Source: Thomson Reuters Datastream, Vontobel Asset Management

Chart 3: Drawdowns in emerging markets are more severe than in developed markets

Drawdown of returns

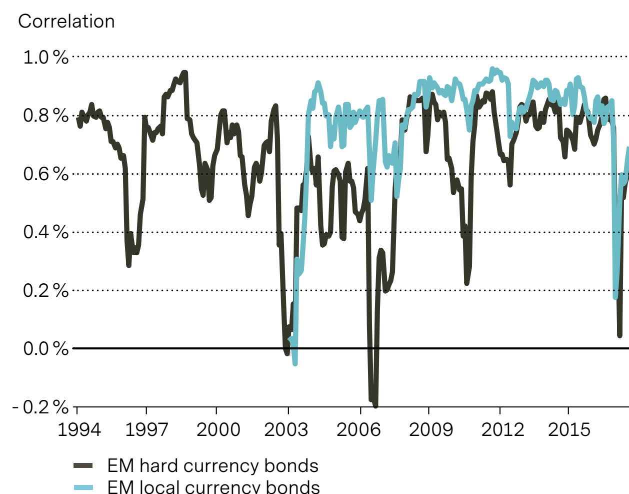


Source: Thomson Reuters Datastream, Vontobel Asset Management

Emerging market government bonds won't offset emerging market equity risk, but may be attractive versus developed market equities

Emerging market government bonds in hard and local currencies are both strongly correlated with their respective equity markets, so buying both offers little diversification. Hard currency bonds are a little more promising as they offer more portfolio diversification potential versus emerging market equities (see chart 4). This fact seems, however, to be at odds with investor preferences, who tend to allocate more money to local currency bonds which will amplify drawdowns.

Chart 4: Emerging market government bonds are strongly correlated with emerging market equities



Emerging market hard currency bonds are represented by the JP Morgan EMBI Global Diversified Index. Emerging market local currency bonds are represented by the JP Morgan GBI-EM Global Diversified Index.

Source: Thomson Reuters Datastream, Vontobel Asset Management

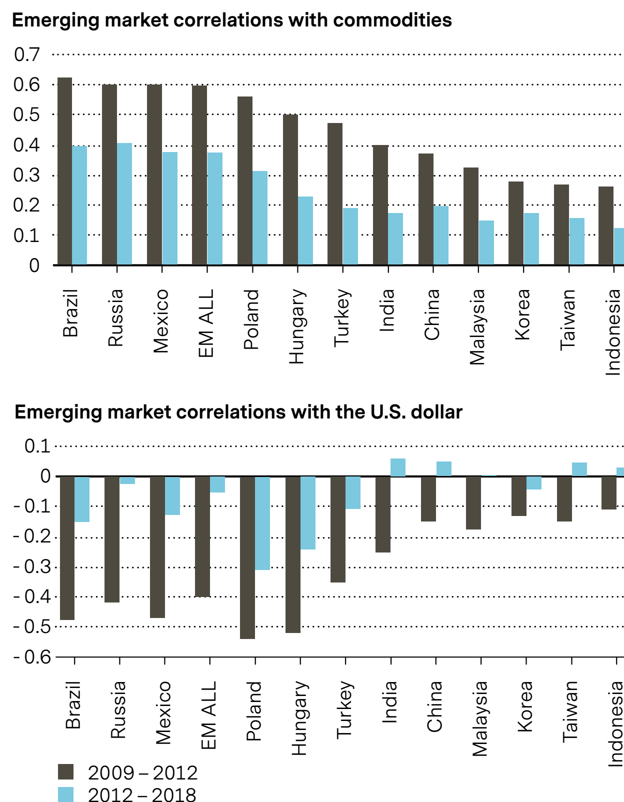
Moreover, as can be seen in chart 1 on page 3, emerging market government bonds exhibit more attractive Sharpe Ratios than developed market equities so shifting capital from the equity bucket to the emerging market bond bucket is likely to improve portfolio characteristics.

U.S. dollar strength and emerging market underperformance are no longer inseparable

Commonly held wisdom was that emerging markets suffer when the U.S. dollar strengthens because many emerging market countries carry large amounts of USD-denominated debt and their economies suffer because the U.S. dollar is the benchmark pricing mechanism for commodities.

However, this picture is gradually changing. Firstly, the U.S. dollar's impact on emerging market equities as a whole is waning as negative correlations between the two are falling. While between 1995 and 2008 emerging market equities easily brushed off a rising U.S. dollar, negative correlation increased markedly between 2009 and 2012 before decreasing again in the period of 2013-2018 (see chart 5). Secondly, U.S. dollar sensitivity is spread unevenly across countries, with some countries becoming more resilient to moves in the U.S. dollar. Asia as an entire region has become less vulnerable to moves in the U.S. dollar whereas other countries such as Mexico, Brazil and Russia have not been able to shake off the U.S. dollar's yoke entirely. Emerging market countries achieved greater resilience against the U.S. dollar by stocking up their foreign currency reserves, reducing hard-currency debt levels, encouraging domestic consumption and devising more credible monetary policies.

Chart 5: Emerging market correlation with commodities and the U.S. dollar have reduced significantly



The various countries are represented by the corresponding MSCI net total return indices (i.e. for Russia the MSCI Russion Net Total Return USD Index was used); for the U.S. dollar the trade-weighted US Dollar Index Spot Rate and for commodities the Bloomberg Commodity Index Total Return were used.

Source: Bloomberg

Emerging market economies are less driven by commodities than in the past

Investors tend to think that emerging market economies are driven by commodity prices, because much of their government tax revenues stem from commodity-producing industries. This belief is misguided because emerging market economies have evolved and are far less dependent on commodity revenues than in the past.

Over the past ten years, many emerging markets have moved towards more services-driven, consumption-based economies with a focus on high tech and consumer discretionary sectors. In fact, 68 percent of industrial goods that are considered as low or medium tech are today produced in emerging markets, and over 48 percent of high tech goods are already manufactured in emerging markets. This structural shift is also visible in the composition of benchmark equity indices. Ten years ago, the largest constituents of the MSCI Emerging Market index were companies from heavy industries such as commodities and energy; names like Petrobras, Gazprom and Vale. Today, the composition of the emerging market index has transformed into one with a bias towards financials, consumer stocks, and technology (with the latter taking the lion's share at around 28 percent).

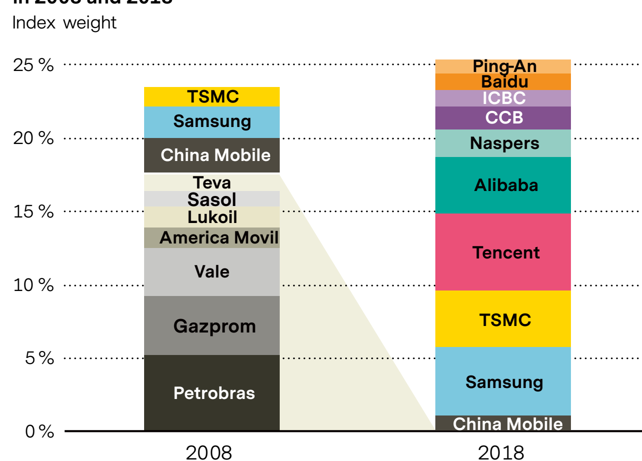
Examples are Samsung Electronics, Taiwan Semiconductors, and the Chinese internet companies Tencent and Alibaba (see chart 6).

So, investors need to make selective allocations amongst different emerging markets in order to achieve a reasonable commodities exposure, balanced by exposures in other industries.

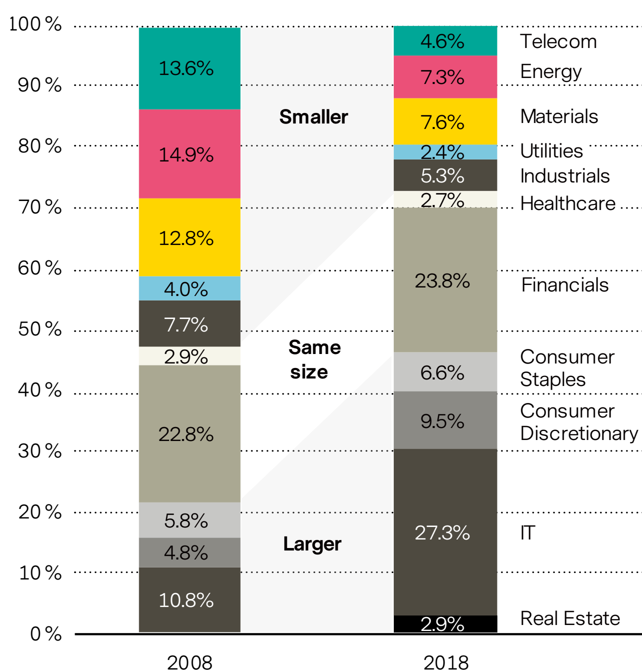
Chart 6: Emerging market economies have significantly changed over the last 10 years

Comparison of the 10 largest constituents of the MSCI EM Index in 2008 and 2018

Index weight



Comparison of the 10 largest constituents of the MSCI EM Index in 2008 and 2018



Source: MSCI, Factset, data as of 30.04.2018

The challenge for emerging market investing is to balance the sector risks, which we have demonstrated are not the same as they were in the past, navigate smoothly through drawdown periods and manage correlations. In our view, an active approach can meet these goals.

Emerging markets – the ideal playground for active management

In developed markets outperforming an index is difficult, making this a privilege for a few highly skilled managers. In contrast, due to their unique characteristics, emerging markets offer ideal conditions for active management to add real value through true alpha generation.

MARKET CHARACTERISTICS ENABLING ALPHA GENERATION	DEVELOPED MARKETS	EMERGING MARKETS
Markets are illiquid or become illiquid in stress periods	Occasionally	Often
Asset class components exhibit return dispersions	Yes, small	Yes, large
Analyst coverage of the underlying securities	High	Low
Behavioral biases are present	Limited	High
Regulatory and governance issues affect ownership and returns	Limited	High

All these criteria are key characteristics of emerging markets as an asset class, so that when deciding on the distribution of active risk across asset classes, investors should favor the emerging market bucket of their portfolios versus developed markets. In our view, it is surprising that 40% of investors choose a passive approach to investing in these markets.

With emerging markets exhibiting all the right conditions for alpha creation, investors might be tempted to choose hedge fund managers to get access to these markets. Such a choice can be disappointing though because many emerging markets impose restrictions on short-selling and the use of derivatives. Instead, attractive returns may be achieved by long-only managers exhibiting above-average tracking errors.

Drilling down further, both emerging market equities and bond markets are inefficient, as demonstrated by the fact that ETFs fail to track emerging market indices with the same degree of accuracy as they follow more efficient developed market indices. While the causes of inefficiency are similar, there are some important differences.

CAUSES OF INEFFICIENCY – EQUITIES	CAUSES OF INEFFICIENCY – FIXED INCOME
Low liquidity and free float	Dispersion of bond performance
Dispersion of company results	Under-researched bonds
Low analyst coverage	Benchmark design
Sustainability risks	Sustainability risks
Behavioral biases	Market segmentation and herd behavior
Weak governance and ownership structures	

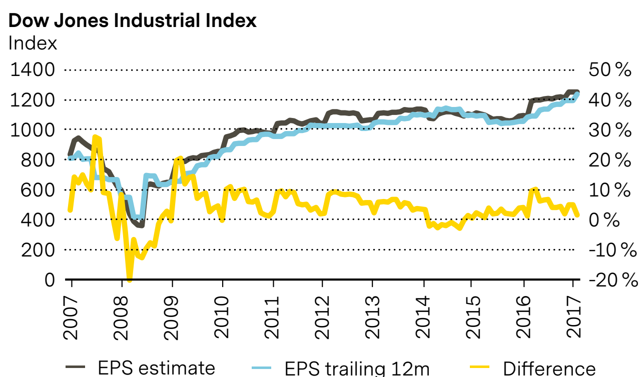
Three causes of inefficiency in emerging market equities you might not be familiar with

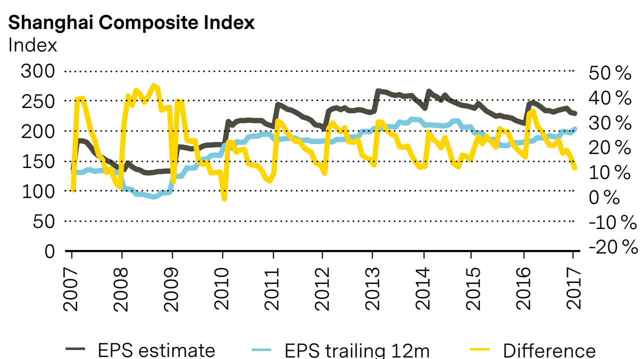
Rather than boring you with charts illustrating well-known issues, we propose to explore three causes of inefficiency that you might not be familiar with yet.

Analyst coverage in emerging markets is low

On a single-stock level, return dispersions are intensified by the relatively low number of analysts covering emerging market companies compared to developed markets. This results in less precise forecasts than in developed markets see (chart 7 on page 8), which opens up opportunities for skilled portfolio managers to outperform. There are also exceptions to the rule, such as the SENSEX index, where on average 41.1 analysts cover each stock, more than the 28.8 analysts covering each Dow Jones Industrial stocks. Again, this creates opportunities for managers able to conduct independent analysis and interpret other research.

Chart 7: Analysts' EPS estimates are less precise for emerging market stocks than for developed markets





Source: Vontobel Asset Management, Bloomberg

Table 8: Developed market and emerging market companies are exposed to different types of risks

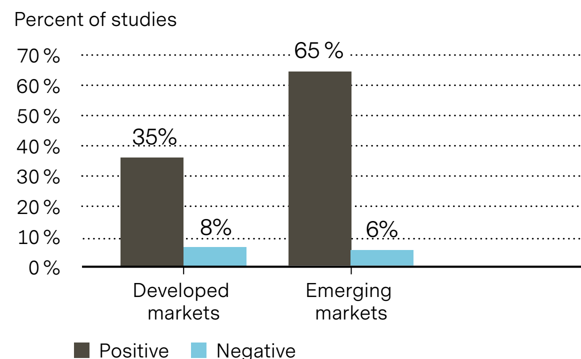
Shading shows difference in risk exposure

	DEVELOPED MARKETS	EMERGING MARKETS
Corruption	3%	24%
Health and safety of workers	12%	30%
Fragile eco-systems	2%	16%
Water scarcity	19%	25%
Strikes	24%	27%
Climate change	44%	40%
Regulation of chemical industry	41%	26%
Privacy regulation	34%	19%
CO_2 regulation	22%	3%

Source: MSCI ESG Research, analysis by Vontobel Asset Management

Based on these differing risk exposures, applying ESG criteria to emerging market investments has greater potential to deliver superior returns than in developed markets. An extensive meta-review of ESG factors investment studies shows that including ESG criteria in your investment approach has positive effects in emerging as well as developed markets. However, in emerging markets such an approach has a greater chance at success with 65% of studies revealing performance-boosting effects. In developed markets this number stands at 35% (see chart 9).

Chart 9: Applying ESG criteria to emerging market investments pays off



Source: Friede, Busch and Bassen review of over 2,000 empirical studies, 2015

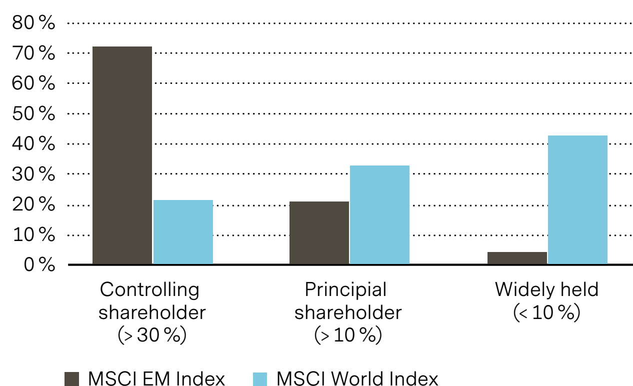
Emerging market companies are exposed to sustainability risks with disruptive potential

Considering environmental, social and governance (ESG) criteria when investing in emerging markets is lucrative. This is not because emerging market companies are exposed to more risks than developed market companies, but because emerging market companies are exposed to different types of risks that are often of a disruptive nature. This leads to greater dispersions of stock performance. Examples are corruption and fragile ecosystems. In contrast, developed market companies have greater exposure to regulatory risks which enforce standardization and, thus, reduce performance dispersion. For a comparison between the two markets please refer to table 8.

Emerging market companies harbor considerable governance risks

Investing in emerging markets is more complex than investing in developed markets, simply because company ownership structures are more complicated. Ownership of emerging market companies is often highly concentrated, exposing minority shareholders to governance risks. This is another factor which enables independent, forensic research to be rewarded.

Chart 10: Most emerging market companies are dominated by a controlling shareholder



Source: MSCI ESG Research, April 2017

Two additional causes of inefficiency in emerging market bond investing

All of the inefficiencies of the equity markets identified in the table on page 7 also apply to the bond market. On top of these, bond markets display some additional inefficiencies, both in general and specific to emerging market investing.

Generally, fixed income investing rewards outside-the-box thinking meaning that many investors set up their risk management systems and investment guidelines so that they form clear "boxes" based on definition of countries, indices and ratings. This, in turn, drives box-based buying and selling. The most common example is when bonds are downgraded, their rating may fall beneath an investment grade threshold, forcing investors inside the "box" to sell, creating an opportunity for investors focused on fundamentals.

Market segmentation and herd behavior strongly affect emerging market bonds investing

In emerging market bond investing there are other common examples of "boxes". These include indices, which are constructed narrowly, and do not fully reflect the breadth of bonds available in the market. This means investors who are able to go off-benchmark can exploit pricing differences, which even exist between benchmark issuers' bonds of different currencies. In addition, investing within a benchmark does not always offer higher liquidity and lower volatility. Because investors frequently switch between risk-on and risk-off behavior en masse, inflows into benchmark constituents from constrained investors such as ETFs can distort prices, again creating opportunities for unconstrained and more creative investors.

Reducing fixed income risks through diversification and sustainability

Many emerging market countries and corporates are subject to the same influences; commodity prices and the U.S. dollar. However, some emerging markets are at a different stage of the development cycle, have more advanced institutions and service-based economies. The trouble is that the most commonly used index families (JPM and Bloomberg Barclays) contain only a small number of countries and are skewed towards commodity producers. That's why you see unwarranted high levels of correlation between countries in the benchmarks that are, however, very different in terms of their economic model and where they are in the economic cycle (see chart 11). This is the case for Turkey and Mexico, for instance, where the correlation is high because the same people trade them at the same time, for the same reasons. Thus, an intelligent manager needs to analyze the portfolio drivers in depth to select exposures in line with his strategic views, rather than blindly following the benchmark.

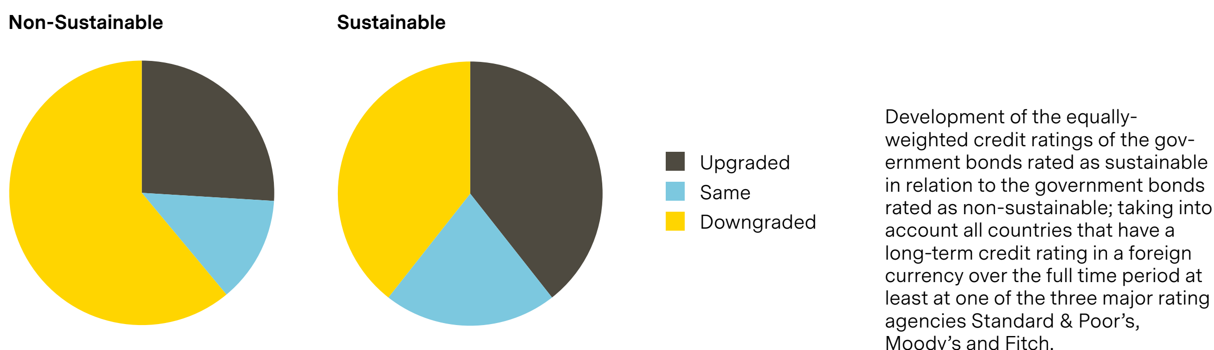
Chart 11: Going off-benchmark avoids correlations between major emerging markets

	EMERGING MARKETS TYPICALLY INCLUDED IN BENCHMARKS								EMS TYPICALLY EXCLUDED FROM BM			
	Brazilian Real	Russian Ruble	Indonesian Rupiah	Malaysian Ringgit	South Korean Won	Mexican Peso	Turkish Lira	South African Rand	Egyptian Pound	Ghana Cedi	Kenyan Shilling	Zambian Kwacha
Brazilian Real		0.50	0.20	0.22	0.13	0.50	0.42	0.52	−0.05	−0.03	−0.04	−0.01
Russian Ruble	0.50		0.25	0.26	0.21	0.45	0.43	0.50	0.01	0.04	−0.04	0.04
Indonesian Rupiah	0.20	0.25		0.60	0.55	0.14	0.14	0.27	0.01	0.05	−0.03	0.02
Malaysian Ringgit	0.22	0.26	0.60		0.63	0.26	0.22	0.31	0.00	0.00	0.00	0.05
South Korean Won	0.13	0.21	0.55	0.63		0.21	0.19	0.25	−0.06	−0.01	0.02	0.06
Mexican Peso	0.50	0.45	0.14	0.26	0.21		0.47	0.55	−0.11	−0.04	0.02	0.05
Turkish Lira	0.42	0.43	0.14	0.22	0.19	0.47		0.56	0.01	−0.04	0.04	−0.06
South African Rand	0.52	0.50	0.27	0.31	0.25	0.55	0.56		−0.02	−0.05	−0.02	0.01
Egyptian Pound	−0.05	0.01	0.01	0.00	−0.06	−0.11	0.01	−0.02		0.11	0.05	0.02
Ghana Cedi	−0.03	0.04	0.05	0.00	−0.01	−0.04	−0.04	−0.05	0.11		0.00	0.02
Kenyan Shilling	−0.04	−0.04	−0.03	0.00	0.02	0.02	0.04	−0.02	0.05	0.00		0.00
Zambian Kwacha	−0.01	0.04	0.02	0.05	0.06	0.05	−0.06	0.01	0.02	0.02	0.00	

Source: Bloomberg, Vontobel Asset Management, 2-year daily correlations, as of 15.03.2018

Just as in equities, sustainable approaches to investing are applicable to bond markets, either at a country or issuer level. Here the thesis is that countries with improving governance and institutions are less likely to risk events such as coup d'états, strikes and IMF intervention and therefore are more likely to service their bonds. Thus, a sustainable approach to bond investing enables a reduction in volatility and reduces portfolio risks. Indeed, since 2007, countries rated sustainable have had an equal number of government bond upgrades and downgrades, whereas downgrades in non-sustainable countries have exceeded upgrades with a ratio of over 2:1 (see chart 12).

Chart 12: Downgrades of government bonds in non-sustainable countries exceed the number of upgrades by far



Development of the equally-weighted credit ratings of the government bonds rated as sustainable in relation to the government bonds rated as non-sustainable; taking into account all countries that have a long-term credit rating in a foreign currency over the full time period at least at one of the three major rating agencies Standard & Poor's, Moody's and Fitch.

Source: Vontobel Asset Management, as of December 29, 2017.

How to invest

In this paper we highlighted a number of major differences between developed markets and emerging markets, and conclude that a smart approach to emerging market investing can be highly lucrative boosting portfolio returns.

While allocations by institutional investors to emerging markets are growing slowly, large commitments to emerging markets may not be for everyone: For the Dutch pension fund, subject to stringent funding and liquidity considerations, a sensible emerging market equity and bond allocation may remain at 5% and 10% respectively. In contrast, others might be able to increase their allocations comfortably to harvest the additional returns that emerging markets have to offer. Those are investors with a long time horizon and the ability to ride out market volatility or those at liberty to pick an effective active investment strategy tailored to the nuances of emerging markets.

Choosing the right manager for an emerging market investment can be complex. As well as considering the usual five Ps of investment (philosophy, people, process, performance, price), and other aspects such as risk management and operations, investors need to assess the quality of the manager's emerging market approach.

Managers of effective emerging market investment strategies should be able to answer the following questions:

Checklist for take-off in emerging markets

1. How does the strategy insulate you against market volatility? Can the manager demonstrate this, for example through upside and downside capture ratios?
2. How does the strategy incorporate ESG criteria which identify and then minimize exposure to emerging market-specific governance risks?
   Does the manager do his own research and is he able to go beyond the inaccurate analyst forecasts typical in emerging markets and untangle complex ownership and shareholding structures?
3. Does the manager avoid structural limitations of emerging market indices by selectively going off-benchmark?
4. Is your manager able to make experts available to validate his approach, explain why he does what he does and show evidence that it works?

About Vontobel

Vontobel Asset Management is an active asset manager with global reach and a multi-boutique approach. Each of our boutiques draws on specialized investment talent, a strong performance culture and robust risk management. We deliver leading-edge solutions for both institutional and private clients.

Our commitment to active management empowers us to invest on the basis of our convictions. We deliver value through our diverse and highly specialized teams. Employing more than 400 professionals worldwide – including 160 investment specialists – we operate across 13 locations including Switzerland, Europe and the U.S. and create strategies and solutions covering equities, fixed income, multi-asset and alternative investments.

Vontobel has a long tradition of investment in emerging markets. Since 1992 we have continuously expanded our emerging market investing activities, and play a leading role in this area with 24 billion Swiss francs in assets under management, as of August 31st 2018, positioning Vontobel Asset Management as one of the leaders in this space, verified by winning 79 investment awards for our emerging market products since 2011.

The goal of achieving excellent and repeatable performance has been fundamental to our approach since 1988. A strong and stable shareholder structure guarantees our entrepreneurial independence and protects the long-term mindset that guides our decision-making.

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